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"Capital increases when a community produces more that it consumes. Capital decreases when the community consumes more than is produces.

Benjamin M. Anderson, Economics and the Public Welfare
1949, Reprint 1979, p. 131, Liberty Press

HIGHLIGHTS

We see three possible scenarios for the DM mark, all with one common denominator: a sizable long-term uptrend. The yen may perform somewhat better over the short-term, but towards the end of the year, if not sooner, the D-mark should reassert its role as the strongest currency.

Scaremongering on German unification is misguided. The first big flaw in the pessimists thinking is the complete disregard for the fact that Germany has the biggest savings and trade surplus in the world upon which it can draw to rebuild East Germany. The oversight of this obvious feature is unbelievable negligence.

Currency and trade adjustment are the release valves that always enter into action when an economy comes under pressure. To get the necessary reallocation of resources, a substantial DM-appreciation is essential, and one way or another, it will occur. It's just a question of timing and who will set it off: market forces left to their own, the Bundesbank or the Fed.

If markets don't volunteer to bring about that outcome on their own, and the Fed abdicates its possible role, it will be left to the Bundesbank to act. And - all courtesies aside - we think there is little doubt that the Bundesbank will.

The U.S. business cycle has proven to be the surest influence on the dollar, the rule being that the effects of the business cycle on the capital account tend to dwarf those on the current account. Although that link is somewhat elastic, a weaker economy ensures a weaker dollar.

The U.S. economy is in the midst of a slowdown that is bound to gain momentum. If it weren't for the many gross statistical distortions, U.S. GNP in the first quarter would have shown a substantial decline rather than a modest increase of 1.3%.

Given the probability of a U.S. recession, we would normally wonder about the implications for the European recovery. The upswing might certainly slow down somewhat, but we think that German unification and the opening of Eastern Europe will keep Europe booming for years to come.

The instant euphoric reaction of U.S. financial and currency markets to the recent doleful employment figures confirms to us that market sentiment - focusing exclusively on the chance for lower interest rates - is still way behind the poor economic realities.

AMERICAN-GERMANY: AN AWESOME DIVERGENCE

The recent short-term strength of the U.S. dollar, in face of truly stupefying economic divergences - particularly with Germany - reminds one that intermediate-term currency actions can be subject to a myriad of temporary influences. While history may show that certain pre-conditions may lead to an inevitable course over the longer-term, the short-term trend isn't always so obliging. Given the recent counter-rally in the U.S. dollar, it's time to review the inevitability of longer-term trends, which in the meantime, have become even more compelling.

EXTERNAL VERSUS INTERNAL INFLUENCES ON THE DOLLAR

Currencies, as always, are subject to two different sets of competing influences: domestic conditions on the one hand, and external on the other. One cannot be discussed without the other. In 1983-84, for example, the long and steep rise of the U.S. dollar was determined primarily by an economic boom that was coupled with exploding domestic credit demand and tight money. Then, these bullish internal influences on the dollar were also reinforced from the outside through lacklustre growth in Europe. As a result, unusually large growth and interest rate differentials emerged in favour of the U.S. economy and its currency.

In addition, there was also an emerging perception that Europe had fallen into an era of slow growth. "Euro-sclerosis" became the buzzword. In this light, the higher dollar-yields were seen as a natural reflection of the greater economic dynamism of the U.S. economy in comparison to that of Europe. Taken together, the soaring dollar reflected a mixture of dollar strength and D-mark weakness.

Under these conditions, though the U.S. trade deficit virtually exploded as imports were sucked in by soaring domestic demand, the dollar shot up from DM 2.40 to DM 3.45 during 1983-84. What happened was that voluntary capital inflows rose even faster than the surging trade deficit. The rise in the dollar indicated that the current deficit was being "over-financed".

Conversely, the dollar has always declined against the D-mark when German and European economic growth accelerated relative to U.S. growth. Historically, that caused interest rate differentials to shrink. As a general observation, the U.S. dollar has been at its weakest when a U.S. recession coincided with a monetary squeeze in Germany.

In hindsight, the U.S. business cycle has proven to be the surest influence on the U.S. dollar, the rule being that the effects of the business cycle on the capital account tend to dwarf those on the current account.

Cyclical Factors the Dominant Influence . . . While this cyclical relationship is highly reliable, it doesn't work with tight precision. This elastic link can be distorted by two main factors: recognition lags in the capital markets (as differentiated from psychology) and adverse monetary conditions.

Citing 1984-85 as an example, the U.S. economic boom had aborted in mid-1984, yet, the dollar continued to surge until late February 1985. It took that long until markets caught up with the reality that the U.S. economy was teetering on the edge of recession. In addition to this recognition lag, there may have been still another factor work to support the dollar: steep declines in U.S. interest rates were luring foreign investors with the prospect of large capital gains on U.S. bonds.

. . . Except When Temporary Monetary Factors Over-ride . . . The yen's recent slide may be another case in point where other factors have temporarily played the dominant role. At first glance, the yen's decline seems to contradict the cyclical rule for the dollar's behaviour. After all, the U.S.

economy is weak relative to the Japanese economy. In this instance, though, the relative monetary conditions are diametrically opposed: tight in the United States and extremely lax in Japan.

In the last example, everything has hinged on the associated monetary conditions. Boom plus monetary laxity causes a falling currency, while the mix of a boom with tight money is the infallible recipe for an appreciating currency. (We shall come back to this point in connection with German economic and monetary unification [Gemu].)

. . . And Delusions Take Hold. The greatest difficulty, as always, is to come to grips with the third major (and most unquantifiable) influence on the markets . . . that being market sentiment and psychology. For a short time, all the fundamental considerations of relative economics and monetary conditions can get thrown out of the window when market psychology leaves reality for delusion.

It is an undisputable fact that the American economy is mired in stagflation. During the first quarter, real GNP grew at a flagging pace of only 1.3%, the inflation rate swelled to 6.7% and productivity fell 2.7% (all taken at annual rates). Yet, Wall Street celebrates this miserable performance as if it were the best of all worlds.

Viewed year-over-year, U.S. real GNP is up 2% while consumer prices have risen 5% and productivity gains have stagnated at zero growth. German real GNP, on the other hand, is up 4.4% on the same basis. The striking difference here is that consumer price have risen only 2.3% and productivity is up a healthy 3.4%.

In principle, so striking a divergence in performance should depress the dollar and buoy the D-mark. Just imagine for a moment where the two currencies would be if the relative conditions in the two countries were reversed. The dollar would in the stratosphere.

But there seems to be a big difference between facts and market psychology. Analysts and market participants seem to be impervious to bad news when it originates from America, while skittish about anything from Germany and Continental Europe. We are tempted to observe that U.S. data must be so poor relative to expectations that everybody contrarily waits for pleasant surprises, while German data are so excellent relative to expectations that everybody suspects unpleasant surprises. Of course, the advent of German unification offers plenty of opportunities for worry and fright.

U.S. COMPLACENCY UNJUSTIFIED

We see two main reasons for the seemingly unshakable complacency over the U.S. economy: first, a general conviction that unfavourable economic statistics are distorted on the downside and that the U.S. economy is therefore actually stronger than it looks; and second, that a recession is, in any case, impossible because the Fed would cut interest rates just in time to spur economic growth during the second half of 1990.

In this rosy view, the weakening of the economy is temporary and healthy. In the first instance, slower growth is seen to imply lower inflation and consequently lower interest rates, which together should buoy U.S. financial markets. In turn, lower interest rates and bullish markets are then expected to usher in the next economic recovery followed with tighter money again and a strong dollar. Business Week's recent headline captures this sentiment: "*This weakling economy is just what the inflation doctor ordered.*"

While the reasons for optimism may not be mutually inclusive, the unifying underpinning to the U.S. financial markets and the dollar - in flagrant defiance of the growing evidence of a weakening economy - is an unbroken faith in the Fed's ability to manage the famous soft landing, that being persistent non-inflationary growth.

Given this underlying bullish sentiment, a major decline of the dollar will probably not occur until the U.S. economy alarmingly slides into a recession, necessitating a much easier monetary policy. Indisputable reality will then jolt complacent delusions.

In that case, a past experience is again instructive. In 1985-87, when the U.S. economy was undeniably weaker than expected, the dollar virtually collapsed from DM 3.45 all the way down to DM 1.57. This collapse happened against the background of lacklustre European economic growth and a shrinking interest rate differential, though still substantial, against the D-Mark. Compare that with conditions in Germany and Europe today.

THE U.S. - GERMAN GROWTH GAP

Given our view and forecast that the coincidence of prolonged U.S. stagflation and new German-European dynamism will lead to a long bearish trend for the U.S. dollar, we should re-explore these two main tenets in light of the latest data and information. What is the true state of the U.S. economy? How long can the markets continue to interpret the weaker-than-expected numbers as good news? And, again, what about the prospects for Continental Europe and the impact of German economic and monetary unification (Gemu)?

The essence of our bullish view is a continued growth gap between the United States and Germany. We already mentioned that U.S. GNP is up 2% and German GNP 4.4% over year-ago levels. The growth rate from the fourth quarter of 1989 to the first quarter of 1990, *as officially reported*, was 1.3% for the U.S. and 2.5% for Germany.

When these recent two numbers were announced and reported by the world press, we recognized at the outset that they were not at all comparable. In no case was it mentioned that the U.S. statistic was an annualized figure and that the German one was not.

Expressed the American way - that being seasonally adjusted at an annualized rate - German GNP rose (actually spurted) more than 10%. Expressed the German way, U.S. GNP rose a meagre 0.3% versus Germany's 2.5%. Either way, U.S. growth is dismal in comparison.

Does the different reporting format make a difference? Is everyone cognizant of this awesome growth gap? To find out, we conducted our own informal poll of analysts and international currency traders.

What did we discover? Everybody polled knew the U.S. growth rate . . . on an annualized basis, of course. None, though, was even close in guesstimating the first quarter growth rate for Germany. Only one individual out of 15 ventured a guess as high as 3%. None, at any rate, had any inkling of the extent of the divergence after applying annualization.

Our little survey draws attention to that fact that though the markets focus on the D-mark heavily, there nevertheless is a general lack of detailed knowledge about Germany. We have no doubt that

in the end the facts will out. It just may take a little longer. But, having discussed the superlative GNP numbers, we must now point out the first quarter results were overstated - both for the United States as well as Germany.

All too understandably, nobody takes a German growth rate of more than 10% too seriously. Growth at that pace is not sustainable. One instantly suspects a statistical fluke which, in fact, there was. In the case of the U.S., though, nobody would suspect a gross overstatement given the laggardly growth rate of 1.3%. But, in fact, there was, too.

In both cases, it's the same culprit: an unusually warm first quarter. What really took place was nothing more than high activity in seasonal industries - especially construction which held up better than usual. The regular seasonal adjustments in conjunction with the regular annualization made a mountain of a molehill. In the case of the United States, statistical magic turned a construction depression into a virtual construction boom.

U.S. NEW CONSTRUCTION
($ Billions)

	OCT.	NOV.	DEC.	JAN.	FEB.	MAR.
Unadjusted	$38.2	36.3	31.8	28.4	28.3	
Adjusted*	411.5	416.5	415.1	425.3	438.6	432.5

* Seasonally adjusted at an annual rate.

Source: Survey of Current Business, April 1990, pp.5-7. U.S. Department of Commerce.

Based on the raw monthly data, construction spending declined $21.3 billion in the first quarter of 1990 to $85 billion from $106.3 in the fourth quarter of 1989. But because of the warm weather, that decline was less than normal. As a result, the normal seasonal adjustment turned the downturn into a "seasonally adjusted" upturn which moreover is annualized. Final result: construction spending rose from $414.4 billion to $432.1 billion or $17.7 billion (at an annual rate).

While construction soared to new heights according to GNP data, other statistics show that the value of new projects has plunged to the lowest level in more than six years.

There are lots of other oddities that puffed up GNP growth in the first quarter. For example, in the case of the automobile industry, seasonal adjustment and the U.S. habit of annualizing these figures transformed a deep slump into a runaway boom with sales increasing 30.7%. The truth is that unadjusted retail sales fell from $176.5 billion in December to $132.6 and $127 billion in January and February, respectively. However the seasonally adjusted figures read as follows: December - $145.8, January - $149.9 and February - $149.5 billion. What happened was that the atypical distress sales of the auto companies and department stores cushioned the normal steep decline of sales from December to January-February.

We'd hazard to guess that not one out of a thousand analysts, traders and journalists really has the faintest idea of how big such distortions can be, especially after annualization. Without these and other gross statistical distortions, U.S. GNP in the first quarter would have shown a substantial decline rather than the modest 1.3% increase. And, the same is true for the fourth quarter of 1989

as we pointed out in the April letter.

As these distortions begin to unwind, the economic data are finally catching up with the reality of a very soft American economy - soft being slower than the "doctor's orders". The instant euphoric reaction of the U.S. bond, stocks and the currency markets to the recent doleful employment figures confirms to us that market sentiment - focusing exclusively on the chance for lower interest rates - is still way behind the poor economic realities.

AGAIN, THE TOPIC OF GERMAN UNIFICATION

Before we draw our conclusions on developments in the United States, the latest data and insights on Germany are in order. We think it's important to realize and emphasize the outrageous contrasts between these two economic entities. As well, the unveiling and the signing of the state treaty between East and West Germany provides the first substantial hard details on unification costs - a refreshing antidote to the many wild, unfounded estimates.

In relation to Germany, the two main questions that preoccupy financial markets are the monetary and fiscal repercussions of the German unification - or in general, the impact on inflation, bond yields and the currency.

As to the first question, Ostmarks will be converted - "devalued" - on average at a rate of 1.83 to 1. This adds about DM 100 billion, or 10%, to West Germany's broad M3 money supply. Since this addition conforms roughly to the relative size of the East German economy, monetary and economic expansion appear rather commensurate.

The other bogey haunting the markets are the potential budgetary costs of unification and their repercussions on both the economy and the markets, especially so the bond market. What matters most, of course, are the combined East-West financing needs. According to the latest estimates, this is projected to rise to DM 90 billion in 1990 and DM 110 billion in 1991. This includes borrowing provisions (altogether DM 17 billion) for the state holding company formed to pre-finance the sale of East German government assets.

PRINTING PRESS OR SAVINGS?

Overall, these amounts correspond to 4% and 5% of West German GNP for the years 1990 and 1991, respectively. That compares with a West German public sector deficit of DM 21 billion or barely 1% of GNP in 1989.

At first glance, no doubt, such a jump in borrowing requirements might appear breath-taking. Many forecasters, considering that this fiscal burst will come on top of a spending spree on the part of private households with their newly created DM balances, have been painting a sombre picture of accelerating inflation, rising interest rates and a weak currency. Our answer: in short, nonsense.

To begin with, this scary story lacks any basis of logic. In theory, for such a scenario to come true it would necessitate one essential key condition: namely, that unification would largely be financed with the printing press. In our view, that's one of the most absurd assumptions one could make. The fact is that Germany has more than sufficient savings at its disposal to take care of unification costs without inflation.

Yet, the "overheating" story is the favourite theme vocalized by large parts of the international press and many analysts. A typical article in BUSINESS WEEK (June 4, 1990) tells of how Chancellor Kohl steam-rolled the Bundesbank and ends with the following conclusion: "*While Pöhl will take control of East Germany's monetary policy, it's a Pyrrhic victory. Kohl has set a limit on the Bundesbank's independence by proving that politics can override its powers. And that, as well as Germany's unity, has been the dream of many a Chancellor*".

Word for word, BUSINESS WEEK's interpretation is untrue. From a German perspective, the first mystery in all this is why the Bundesbank should be so timorous in applying the monetary brakes if the German economy would overheat. Last year, we should remember, the bank raised its discount rate from 3.5% to 6% and its lombard rate from 5.5% to 8% when the economy looked much less buoyant. Yet, even as inflation was only a little over 3%, there was not a single voice of dissent from the public or the politicians.

The main argument of those who postulate the loss of independence and credibility of the Bundesbank is that, given the inflationary risks inherent in economic and monetary unification, the bank ought to have followed the bond market in raising short-term interest rates, too. For these critics, failure of the Bundesbank to have done so is sufficient proof that it has lost its legendary anti-inflationary zeal.

It's true that the Bundesbank, too, has warned of inflationary risks. But the "trouble" with these warnings is that month after month inflation proves lower than expected despite the booming economy. Consumer price inflation has only been 2.3% for the last three months, 2.5% for the last six months and 2.3% year-over-year. At the same time, the money supply (M3) is well within its target range.

Which central bank in the world would raise its interest rates under such extra-ordinary conditions? It seems to us that the American, British and Japanese analysts and reporters who are writing with crocodile tears about the Bundesbank's loss of independence are mixing up the situation in their own countries with that in Germany.

What all the Gemu pessimists overlook, apparently, is that both Germany's government and central bank are acting from a position of unprecedented economic and financial strength. One man who knows it is Kohl, which goes a long way to explain his surprising boldness. And one should also not forget that West Germany's economy is about ten times larger than that of East Germany.

In gauging the various budgetary implications, we like to distinguish between two main aspects: firstly, the Keynesian fiscal or demand effects; and second, the changes in the supply-demand conditions in the capital market, in other words, "supply shock" in the bond market relative to the availability of savings.

Clearly, the "fiscal impulse" measured by the increase in total government borrowing as a share of GNP is no less than phenomenal. What's more, it will hit an economy whose productive capacity is already rather strained. From this perspective, accelerating inflation and further rises in German interest rates seem almost compelling. But, a closer look at the relevant numbers yields a more comforting conclusion.

GERMANY: PUBLIC FINANCES
(IN BILLIONS DM)

Surplus (+) or Deficit (-)	1988	1989	1990	1991
Central, Regional and Local Authorities	-53.5	-21.0	-90.0	-110.0
Social Security Funds	- 1.3	+13.5	+13.0	+ 23.0
Net Borrowing	-54.9	-7.5	-77.0	- 87.0

The figures in Table 2 elucidate an important point. It's the fact that the steep rise in public borrowing requirements from 1989 to 1990-91 stems largely from the prior extremely low borrowing needs in 1989. When compared to 1988 the borrowing volumes in 1990 appear much more modest, particularly if one takes into account the surplus in the social security funds.

After years of fiscal restraint, the fact is that West Germany's public finances are in the best shape of the last twenty or thirty years. Since the inception of the Kohl era, government spending has been reduced from a ratio (relative to GNP) of 52% in 1982 all the way down to 46.5% in 1989. That performance in turn enabled the government to reduce the overall tax ratio to the same low level of the late 1950s.

Then what about the second concern of international bond investors: an unmanageable jump in the borrowing requirements relative to available savings?

The mentioned public borrowing needs of DM 90 billion for 1990 and DM 110 billion for 1991 will be matched by an annual West German personal savings supply of well over DM 200 billion, even higher than the DM 193 billion recorded last year. Certainly, it's also reasonable to assume that the East Germans will contribute some additional DM 10-20 billion annually from their future income in hard D-mark.

However, these are only the borrowing requirements of the public sector. On top of these amounts come surging credit and capital demand for business investment and building. Together, the net external capital requirements of the two sectors may add up to DM 80 billion or possibly somewhat higher.

INTERNATIONAL CROWDING OUT

Clearly, the problem for the German bond market, does not find root in a true lack of savings to finance unification and its domestic investment boom. Rather, Germany has to reallocate its domestic savings of which too much has flown abroad in past years. For example, in 1988 and 1989, capital outflows were around DM 120 billion in each year.

This swing-valve of capital outflows essentially frames the key objective of the Bundesbank. It has to reduce the supply of savings to the rest of the world to mobilize them for domestic purposes. No more, no less. Putting it differently, competitive foreign demand for German savings has to be crowded out. Why such a process should be bad for the German market and good for all other markets - as many analysts assert who forecast rising bond yields in Germany and falling bond yields

elsewhere - is a logic that is totally beyond our grasp.

As far as the German investor is concerned, this crowding out process has already started with a vengeance. During the first quarter of this year, net purchases of DM-bonds by domestic banks and investors exceeded DM 60 billion (an annual rate DM 240 billion). Net purchases of foreign currency bonds were at a bare trickle amounting to only DM 2-3 billion. Foreign investors went the other way, however, and unloaded DM 12 billion of DM bonds.

Surely, the above figures provide clear evidence that the defamatory stories about a confrontation between government and Bundesbank - rampant in London and New York - find no ears in Germany itself. But, while the Bundesbank regards the sharp rise in DM bond yields as a panic reaction, it is not unhappy since it obviously fits the domestic policy requirements well.

EXACTLY THE DESIRABLE POLICY MIX

The key to the interest rate outlook over the longer run, in our view, is the exchange rate. Foreign investors would not have unloaded their German bonds and German long-term interest rates would not have risen to these heights if the markets sensed a rising D-mark. Underlying market sentiment on the D-mark has been and continues to be far from bullish, to say the least. Therefore, higher interest rates have been necessary to hold the currency.

We have expressed our dissent with this view of a weak D-mark and a strong dollar often enough. Our argument is that the combination of a booming German economy, surging public and private credit and capital demand, record high real interest rates and the high potential returns of physical investment following unification will over time drastically strengthen the German capital balance and drive up the D-mark. German investors, as shown, have already reacted with conviction. Foreign investors one day will follow suit.

Many analysts argue that sharply higher budget deficits in Germany will raise interest rates and weaken the D-mark. However, the over-riding experience of the 1980s has been the exact opposite - provided that monetary policy is not accommodative. The most famous example of this phenomenon at work, of course, was Reaganomics. And in reality, that mix of conditions is nothing less than the standard policy by which all the countries with large deficits (Canada, Australia, Italy, Spain . . . etc.) have achieved their strong currencies. Why shouldn't the same policy work for a country with a large current account surplus, like Germany?

Actually, the prescription of an expansive budget and tight money fits precisely as the most desirable policy mix for Germany, both domestically and internationally. Such a policy will inevitably strengthen the capital account and drive up the D-mark while bolstering imports. Currency appreciation, in turn, sets in motion the implicit and crucial process which caps German inflation as domestic demand growth outstrips current output growth (and probably so by a wide margin).

GERMAN TRADE AND CAPITAL IMPLOSION

The facilitating process will be a massive implosion of Germany's capital and trade balance. To quote the IMF (World Economic Outlook, May 1990, p.75): *"The mechanism underlying this process would be a rise in the real effective value of the Deutsche mark reflecting the increase in real interest rates in Germany."*

Many people lament the fact that German unification will accelerate inflation as it impacts an economy that is already hitting capacity limits. Nobody ever gives any consideration to the fact that Germany, after all, has huge resources at its disposal that will enable it to manage this gigantic transformation without inflation. To gain a perspective on the weight of our point consider the following facts: the German annual export and savings surplus is currently running at about 5% of West German GNP, which is half of the entire GNP of East Germany. Presently, it is the biggest surplus in the world. Given, the true enormity of the inflation-buffer represented by the present trade surplus, we are somewhat unhappy with the Bundesbank's failure to better communicate this reality to the international capital markets.

The only question now is, what mechanism can be expected to help staunch this flow of resources to the rest of the world in order to redirect them to the task of rebuilding East Germany. As the IMF quote alludes, there are only two possible levers that can bring about the massive reallocation of resources: interest rates and the exchange rate. The primary objective of the Bundesbank must be the reversal of capital outflows. What this means, simply, is that the money outflows from Germany - which have weakened the D-mark - must stop flowing out and/or begin to flow back in. This necessary change in the tide is what we call the implosion process. The consequence is that an appreciating D-mark boosts the affordability and volume of German imports, which is the natural counterpart to the capital implosion.

This strengthening of the German capital account and the associated DM-appreciation may come about either by lower U.S. and foreign interest rates or by still higher German interest rates.

To be quite frank, we are more than astonished that in our time of global markets there can still be such a narrow-minded line of argument as the pessimists display. Why can any country with large deficits and sky-high foreign debts import capital without limit apparently, but not Germany? Is German creditworthiness the problem?

Just as grotesque in the whole discussion about the costs of Gemu is the fact that the huge German export and savings surplus is never mentioned as big potential reserve of capital and resources that Germany can draw upon. The truth is that Germany is able to rebuild East Germany out of its own current production, current income, current savings, and yet possibly remain a surplus country. In our view, it would be the task of the Bundesbank, to communicate these facts plainly to the rest of the world. Importantly, it should explain the strategic concept most of all.

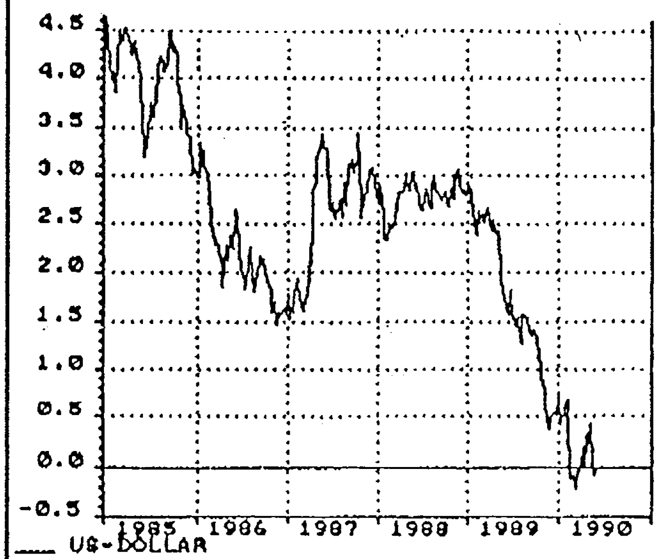
THREE POSSIBLE ALTERNATIVES

If Gemu were to come about with no change in the current state of huge exports of merchandise and excess capital, we would be the last ones to deny that Gemu would imply rapidly rising inflation. But to assume no change is an impossible assumption. To get the necessary massive reallocation of resources, a substantial DM-appreciation is essential, and one way or another, it will occur. It's just a question of timing and as to who will set it off: market forces left to their own, the Bundesbank or the Fed.

In theory, spontaneous market forces could do the job. Perhaps, for some reason, market sentiment on D-mark prospects improves and the shift comes about voluntarily and gradually. As capital inflows into Germany gain momentum, bond yields move inversely with the currency. Bond yields stabilize or decline while the DM appreciates against the dollar. Strong import and price effects of

a appreciating D-mark keep domestic inflation in check. Consequently, there is no need for the Bundesbank to tighten and raise interest rates further as the necessary tightening occurs through the exchange rate.

GERMAN/US INTEREST RATE DIFFERENTIAL



Source: Datastream

In fact, that's what the Bundesbank wants and hopes for. Unquestionably, this path of adjustment would also be in the best interest of the rest of the world. The only possibly unpalatable aspect is that long-term interest rates in the rest of the world would rise relative to German rates.

Given the hysterical market reactions, things may well take a different course if the big turnaround in the German capital balance and the required substantial DM-appreciation fails to materialize. The Bundesbank would then be confronted with growing inflation pressures and a D-mark suffering from bouts of weakness. To contain inflation, the Bundesbank would have to slam on the brakes. Internationally attractive and inflation-secure interest rates in Germany would then be the catalyst that accelerates capital inflows, driving up the D-mark.

The third possibility, finally, is that the D-mark appreciates because the U.S. economy slides into a recession thus forcing the Fed into a sizable easing. Downward pressure on the dollar from lower interest rates could initially be offset by capital inflows attracted by opportunities in the U.S. bond market. In fact, that phenomenon seems to be in play as we write. But that effect won't last long. The overwhelming cyclical influence of a recession would eventually mean a sharply falling dollar and that will quickly quench the appetite of foreigners for the U.S. bond market.

We see three possible alternatives, all with one common denominator: a sizable appreciation in the D-mark. If markets don't volunteer, and the Fed abdicates its role, it will be left to the Bundesbank to act. And, all courtesies aside, it will.

SUMMARY CONCLUSIONS

The German economy is strong beyond expectations while the American economy is weaker than expectations. U.S. economic data now paint an unequivocal picture of sluggishness. That runs diametrically counter to the consensus forecast of an imminent recovery on the back of continued strong employment and income growth that is expected to fuel consumption.

The most important point to see is that recent employment data have literally made shambles of this key assumption underlying the prior optimistic growth forecasts. Service employment, heretofore the bulwark of employment strength, proved far weaker than expected.

These are fundamental facts, yet everybody - including Mr. Greenspan - rushes to assert and assure that there is "*no underlying deterioration*" in the U.S. economy and that a recession is impossible. The truth - which all prefer to ignore - is that once an economic decline gets under way, it tends to gather momentum.

Germany's and Continental Europe's new dynamism is based on surging investment and capital formation, not overconsumption and under-saving as in the U.S. and the other deficit-countries. Germany has taken on the role of the European locomotive. German unification will strengthen and not weaken this role.

Given the probability of a U.S. recession, we would normally ask ourselves whether it might not also derail the European recovery. It might certainly slow down somewhat, but we think German unification and the opening of Eastern Europe will keep Western Europe booming for years to come.

All this should lead to a very strong D-mark over the long-run, easily hitting new highs against the U.S. dollar. It's possible that exaggerated worries about German unification may delay a decisive appreciation for a while. Over the next few months the yen may perform rather better, although, in contrast to the D-mark, the yen is vulnerable to a U.S. recession. Towards the end of the year, if not sooner, the D-mark should take over as the strongest currency.

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